COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, OCTOBER 19, 2000

COMMONWEALTH OF VIRGINIA

At the relation of the

STATE CORPORATION COMMISSION

CASE NO. PUA000029

Ex Parte: In the matter concerning
the functional separation of incumbent
electric utilities under the Virginia Electric Utility
Restructuring Act

FINAL ORDER

This Order promulgates regulations governing the functional separation of incumbent electric utilities' generation, transmission and distribution services by January 1, 2002. Section 56-590 of the Virginia Electric Utility Restructuring Act ("the Act") establishes the functional separation requirement, and directs incumbent electric utilities to submit proposed functional separation plans to the Virginia State Corporation Commission ("the Commission") by January 1, 2001. The Commission is directed by § 56-590 to promulgate rules and regulations in furtherance of its provisions "to the extent necessary to promote effective competition in the Commonwealth."

On April 18, 2000, the Commission issued an order inviting interested persons to file comments or request a hearing concerning proposed regulations implementing the provisions of § 56-590 that were attached to that Order. Comments and requests for hearing were to be filed on or before May 22, 2000. However, on May 15, 2000, Virginia Electric and Power Company ("Virginia Power"), The Potomac Edison Company d/b/a/ Allegheny Power ("Allegheny"), and

thirteen jurisdictional electric cooperatives, together with Old Dominion Electric Cooperative, and the Virginia, Maryland & Delaware Association of Electric Cooperatives ("the Cooperatives") filed a joint motion for an extension of time in which to file comments and requests for hearing in this proceeding. The Commission, thereafter, by order dated May 19, 2000, extended the time to file comments concerning the proposed rules to June 12, 2000.

The following parties filed comments concerning the proposed rules: Virginia Power; AEP-Virginia ("AEP"); the Office of the Attorney General's Division of Consumer Counsel ("Consumer Counsel"); Allegheny; the Cooperatives (filing jointly); the Virginia Independent Power Producers, Inc. ("Independent Power Producers"); Washington Gas Light Company ("Washington Gas"); the Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (filing jointly) ("the Committees"); Kentucky Utilities Company d/b/a/ Old Dominion Power Company ("Kentucky Utilities"); and RGC Resources, Inc. ("RGC"). No party requested a hearing.

NOW UPON CONSIDERATION of the pleadings and comments filed herein, we find that we should adopt the rules appended to this order as Attachment A, applicable to the implementation of § 56-590 of the Act, effective as of the date of this Order. While we will not review each rule in detail, we will comment briefly on several of them.

First, we note that Kentucky Utilities and the Cooperatives have requested certain exemptions from the operation of the rules we adopt in this Order. In the case of Kentucky Utilities, that company states that it has no generation facilities and only limited transmission facilities located in Virginia, and that its Virginia operations account for less than five percent of its overall business operations. Consequently, Kentucky Utilities asks the Commission to accept in fulfillment of § 56-590's requirements, Kentucky Utilities' compliance with a code of conduct

established under Kentucky law (HB 897 of 2000) that governs relations between utilities and their affiliates. The Cooperatives have requested that the final regulations include within the definition of "affiliated generation company" and "transmission provider," exemptions for those assets or facilities operated by an incumbent electric utility primarily for the maintenance and control of the distribution function. The Cooperatives have also proposed other exemptions, including an exemption for electric cooperatives that purchase all of their generation from the Tennessee Valley Authority ("TVA"), from any provisions of the Commissions' rules that may conflict with retail rates set for any such cooperative by TVA.

Section 56-590 does not authorize the Commission to exempt any incumbent electric utility from the requirement to file a functional separation plan with the Commission by January 1, 2001. However, certain provisions of these rules may be inapplicable in certain circumstances. Consequently, we have established in 20 VAC 5-202-50 A a procedure for reviewing waiver requests, such as those raised by Kentucky Utilities and the Cooperatives, on a case-by-case basis. This procedure is consistent with the approach we have taken in other restructuring-related rulemakings, and offers, in our estimation, an orderly manner in which to take up concerns such as those described above.

Second, we address the definition of "generation company" in 20 VAC 5-202-20 as a person "owning, controlling, or operating a facility that produces electric energy for sale to *wholesale customers*." (emphasis supplied). Consumer Counsel suggests that the definition be expanded to include generation companies that provide sales at retail. However, we believe that limiting the applicability of these regulations to generation companies making sales at wholesale will eliminate potentially confusing overlap between these rules and the Interim Rules Governing Electric and Natural Gas Retail Access Pilot Programs ("pilot rules") adopted in Case

No. PUE980812. Any company that makes retail sales must be licensed as a competitive service provider and is subject to the pilot rules. Moreover, if parties are concerned about potential gaps between these two sets of rules as to the treatment of incumbent electric utilities and their affiliates, we note that their provisions are virtually identical. In that vein, AEP and Allegheny question in their comments whether utilities that are registered holding companies should be subject to the asymmetrical pricing standard set forth in 20 VAC 5-202-30 B 5. We note that the pilot rules impose an identical requirement in 20 VAC 5-311-30 A 10. Additionally, Virginia Power, AEP and Kentucky Utilities question the necessity of the provisions of 20 VAC 5-202-30 B 6 and 7 that place reporting requirements on affiliated generation companies pertaining to tracking of employees; the companies' affiliate relationships with local distribution companies; and complaint investigations. We believe these requirements are appropriate and necessary. Moreover, they parallel similar requirements established in the pilot rules under 20 VAC 5-311-30 A 9 c, 20 VAC 5-311-20 B 6 c, and 20 VAC 5-311-60 G.

Both the Consumer Counsel and the Committees have expressed concern in their comments that provisions in 20 VAC 5-202-30 may have the effect of making permanent the provisions of the pilot rules concerning affiliate relationships. The Commission has, as much a possible, made the affiliate requirements in these rules mirror those in the pilot rules. At this point in time, we believe it would be inappropriate to apply any restrictions in these rules concerning affiliate relations that are tighter than those imposed in the pilot rules. We would note, however, that as the restructuring process advances along its statutory timeline, we would anticipate changes in the provisions of 20 VAC 5-202-30 corresponding to the competitive market's development and evolution.

Third, AEP, Virginia Power, and Allegheny opposed the requirements of proposed 20 VAC 5-202-40 B 6 requiring that incumbent electric utilities provide the fair market value of generation assets, even if they intend to transfer these assets at book value. These companies contend that to the extent that transfers to functionally separate units will be made at book value, a market valuation is unnecessary. Similarly, AEP, Virginia Power, and the Independent Power Producers opposed a related requirement in proposed 20 VAC 5-202-40 B 6 requiring that incumbent electric utilities provide a year-by-year fair market valuation of long-term power contracts. In our view, the fair market value of (i) generation assets at the time of their sale or transfer, and (ii) long-term power contracts on a year-to-year basis is information that is critical to the Legislative Transition Task Force's ("LTTF") assessment of stranded cost recovery pursuant to the provisions of § 56-595. However, while the Commission is required by this statute to assist the LTTF in monitoring stranded cost recovery, we will defer to the LTTF to determine as soon as possible, by resolution or some other specific directive to the Commission, whether it will want this information for its use in monitoring utilities' recovery of stranded costs. Thus, in final rule 20 VAC 5-202-40 B 6 c, the fair market valuation of generation assets and purchase power contracts will be required by the Commission if and when the LTTF directs the Commission to obtain that information for its use pursuant to the LTTF's obligations under § 56-595 of the Act.

Fourth, our final rules respond to AEP's concerns regarding proposed rule 20 VAC 5-202-40 B 10, and its treatment of potentially confidential, proprietary or competitively sensitive information. As proposed, the rule permitted an incumbent electric utility to request confidential treatment for any information submitted as part of a functional separation plan, and to furnish the reasons for such requested treatment. AEP believes that the rule should go further to require

preliminary, confidential treatment of such information by the Commission pending its final determination of confidentiality. Moreover, AEP believes it should have the opportunity to withdraw any information it deems confidential if the Commission decides to permit its public disclosure, e.g., if the Commission determines that in its view the information is not confidential, proprietary, etc. We have responded to AEP's concerns in 20 VAC 5-202-50 B of the final rules by permitting any filing containing information declared confidential by the applicant to be filed under seal, while also making provision for public disclosure of redacted versions. Such information will be treated as confidential pending the Commission's ultimate determination of its appropriate treatment. However, unredacted versions must be made available by any such incumbent for immediate, internal use by the Commission's Staff.

Fifth, with respect to the functional separation plan filing requirements detailed in 20 VAC 5-202-40, we note that substantially less information is required to be filed under the rule we adopt today, as compared to the provisions of 20 VAC 5-202-40 when issued for comment under our April 18, 2000 order. For example, we have eliminated the filing of information concerning (i) the likely impact of proposed functional separation on the capital structure of incumbent utilities, (ii) anticipated long term capital structures of the functionally separate entities resulting from proposed functional separation plans, (iii) mediation steps taken to avoid violating any existing debt indentures, (iv) expected transaction costs or refinancing costs required to effect functional separation, (v) changes to existing credit support arrangements, (vi) intended use of cash proceeds in the event of divestiture, (vii) methods proposed for allocating any net gains or net losses between ratepayers and shareholders in the event of divestiture, (viii) any current or anticipated Securities and Exchange Commission authorizations for securities to be issued in connection with a functional separation plan, and

(ix) proposed dividend policies concerning dividends from any proposed functionally separate entity to any parent entities following functional separation. We have eliminated from the final rules the filing requirements described above because, in our view, information falling into these categories can be requested by the Staff on a case-by-case basis under the Commission's discovery rules, if and when such information is required in the public interest.

Sixth, we have provided in 20 VAC 5-202-50 C that, except for good cause shown, incumbent electric utilities planning to transfer generation assets in connection with their functional separation shall submit Transfers Act applications concurrent with the filing of their functional separation plan. We believe this will help streamline the process for the incumbents and the Commission.

Seventh, 20 VAC 5-202-40 B 7 requires that each functional separation plan include a detailed cost of service study reflecting total company and total Virginia operations. The cost of service study must be based upon a test year beginning no earlier than January 1, 1999. This information is essential to the unbundling of utilities' rates for purposes of determining (i) unbundled generation rates to be utilized in calculating wires charges for shopping customers pursuant to § 56-583, and (ii) unbundled distribution and transmission rates to be utilized during the capped rate period under § 56-582. We note that we have eliminated from the adopted version of this rule, the requirement in the proposed version of rule that the seven-factor test set forth in Order 888 of the Federal Energy Regulatory Commission ("FERC") be utilized for the purpose of separating transmission and distribution in conjunction with this unbundling process. We are adopting this approach in the interest of reducing complexity in this part of the application.

Finally, we turn to the provisions of 20 VAC 5-202-40 B 6 g, h, and i in which incumbents are asked to provide assessments of how their functional separation plans advance or satisfy their obligations under the Act to (i) make electric service available at the capped rates established under § 56-582, and (ii) provide default service as a default supplier pursuant to § 56-585. In the case of default service, incumbents are also asked to include a "detailed description of pricing and capacity if the incumbent electric utility proposes to utilize equivalent generation in satisfaction of such obligation." Incumbents intending to utilize equivalent generation are further required to provide an analysis of the cost of retaining generation compared to the cost of obtaining equivalent generation, if the incumbents intend to divest all or part of their generation assets supporting Virginia load. Finally, these rules also require the incumbents to explain how (i) equivalent generation will provide rates, reliability and capacity comparable to the generation assets currently held by the incumbents and, (ii) obtaining equivalent generation is in the public interest.

The requirements of 20 VAC 5-202-40 B 6 g, h, and i reflect the interaction among §§ 56-590 B 3, 56-582, 56-585 and 56-90. First, § 56-590 B 3 authorizes the Commission to impose conditions, consistent with the public interest, on an incumbent's functional separation plan,

> . . . including requirements that (i) the incumbent electric utility's generation assets or their equivalent remain available for electric service during the capped rate period as provided in § 56-582 [and] during any period the incumbent electric utility serves as a default provider as provided for in § 56-585. . ..

Put simply, § 56-590 B 3 authorizes the Commission to ensure that every incumbent's plan for functional separation supports the incumbent's statutory obligation to provide capped rate service and default service as required by the Act. To that end, this statute provides that the Commission

may require that incumbents' generation assets remain available, or that equivalent assets remain available to support (i) regulated capped rate service, and (ii) regulated default service. This provision, therefore, places a specific limitation on the exercise of incumbents' discretion to dispose of their generation units in conjunction with the implementation of the Restructuring Act.[1] This requirement complements § 56-90 of the Transfers Act, a provision that prohibits this Commission from approving transfers of utility assets, unless such transfers will not impair or jeopardize adequate service to the public at just and reasonable rates.[2]

20 VAC 5-202-40 B 6 g, h, and i require the filing of information we believe necessary to discharge our duties under the Restructuring Act; specifically, our obligation to ensure that the generation component of incumbent utilities' capped and default rates can be supported, in fact. Therefore, to the extent that an incumbent's plan for functional separation calls for total or partial divestiture of generation assets supporting Virginia load, our rules require the incumbent to provide this Commission with the information it needs to determine how the incumbent can fulfill its obligations under the Act.

AEP and Virginia Power devoted considerable time to the meaning of the term "generation assets or their equivalent" in their comments opposing the provisions of 20 VAC 5-202-40 B 6 g, h, and i. Virginia Power, for example, asserts that in the context of default service, equivalency pertains only to an amount of capacity and not to the price of that capacity. Thus, under that construction, once capped rates are terminated or expire, any default service provided thereafter will simply be a "pass through" at market rates—whatever those rates may be. AEP

[1] This is consistent with the provisions of § 56-577 A 1 stating that on and after January 1, 2002, generation is no longer subject to regulation, *except as otherwise specified in the Restructuring Act*.

[2] We note that § 56-590 G, explicitly provides that nothing in the Act shall be deemed to abrogate or modify the Commission's authority under Chapter 5 (the Transfers Act). Consonant with that provision, 20 VAC 5-202-50 C

takes a somewhat different tack, contending that it is up to each incumbent electric utility—and not this Commission—to decide whether capped and default rates will be supported with utilities' generation assets, or with equivalent assets. Under that view, even a nondivesting utility would be the ultimate arbiter of whether its own generation, or some equivalent, would back its capped rate and default service obligations. Under either view, however, the incumbent's sole obligation concerning default service is reduced simply to keeping energized the distribution lines to customers in their former service territories.

We find no basis for AEP's contention in the plain language of § 56-590 B 3; the statute clearly addresses the authority of the Commission to impose conditions upon functional separation plans in the public interest. The statute makes no reference to incumbent options in this context.

With respect to Virginia Power's default service "pass through" position, we note, preliminarily, that § 56-585 C provides that the rates for default service are regulated rates to be established by the Commission pursuant to Chapter 10 of Title 56—the source of our traditional ratemaking authority—and § 56-585 B 3. Section 56-585 B 3 declares that when incumbents are required to furnish default service, their rates must be fairly compensatory to the utility and "[r]eflect any cost of energy prudently procured, including energy procured from the competitive market . . .." Chapter 10 requires that rates be just and reasonable.

Virginia Power relies on § 56-585 B 3 as a primary basis for its argument that a utility may satisfy its potential default service obligation simply by procuring energy from the competitive market and passing the cost of that capacity through to default customers. Thus, according to the company, default service is merely an assurance of capacity availability, and not

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requires each incumbent electric utility to file simultaneously with its functional separation plan any Transfers Act application such a utility must make for purposes of transferring assets.

the price of that capacity. Consequently, it asserts, the Commission has no basis under § 56-590 B 3 to inquire into the price of any purchased power substituted for an incumbent utility's generation, i.e., purchased power that an incumbent utility might offer in its functional separation plan for purposes of supporting its default service obligation. Under Virginia Power's reading of the Act, if an incumbent electric utility, such as Virginia Power, decides to divest its generation assets, default service electric customers in that utility's service territory will have no regulated rate protections under the Act once capped rates are terminated (potentially between 2004 and 2007) or expire by operation of law on July 1, 2007. In our view, this interpretation does not square with the provisions of the Act, taken as a whole.

Default service, regardless of whether provided before or after the termination or expiration of capped rates, is, by the express terms of § 56-585, provided through rates regulated under the provisions of Chapter 10 and § 56-585 B 3. We do not read § 56-585 B 3 simply as a vehicle for passing through market rates to default service customers. Section 56-585 B 3 provides that the Commission may require an incumbent utility (or its affiliate) to provide default service at rates that "are fairly compensatory" and reflect prudently purchased power "including energy procured from the competitive market . . .." Virginia Power's argument focuses primarily on a single phrase in § 56-585 B 3 allowing the flow-through of prudently purchased power from the competitive market as the basis for concluding that the Commission may not consider the cost or price aspects of "equivalent" generation in applying § 56-590 B 3. Such an argument would have us ignore the remaining language of that section and the very specific provisions of § 56-585 C and D. This we cannot do; the Act must be considered as a whole.

First, as noted above, § 56-585 B 3 does not refer solely to the pass-through of purchased power from the competitive market. The section provides generally that rates must be "fairly

compensatory" and allows the flow-through of purchased power. This is, essentially, a reaffirmation of the basics of regulated rates found in Chapter 10 of Title 56, and protects both the provider and the customer. The language "fairly compensatory" appears to refer to the requirements found in § 56-235.2 that public utilities recover their actual cost of service and a fair rate of return on their rate base used to service jurisdictional customers. Reference to the recovery of prudently incurred purchase power costs in § 56-585 B 3 restates part of § 56-249.6 that authorizes utilities to recover prudently-incurred purchased power costs. There is no suggestion in § 56-585 B 3 or elsewhere that the Commission cannot or should not consider what those costs might be when determining under § 56-590 B 3 whether to require a utility in its functional separation plan to retain its generation assets or their equivalent during the rate cap period, or when the utility serves as a default provider under § 56-585.

The express provisions of § 56-585 C are also critical to our analysis. This section provides that the Commission shall "determine the rates, terms and conditions" of default service consistent with the provisions of § 56-585 B 3 and Chapter 10 of Title 56. The Commission is also authorized to "use any rate method that promotes the public interest . . .." Thus, the Commission is given both direction and discretion in establishing rates for default service. Section 56-585 C leaves no doubt that the Commission is obligated to establish rates for default service. Virginia Power's interpretation of the Act would appear to render the General Assembly's ratemaking directives in § 56-585 C meaningless and further require that we disregard them when applying § 56-590 B 3. We must, however, read the statute as a whole and consider our ratemaking obligations for default service when we examine functional separation plans. Indeed, considering such ratemaking obligations is in furtherance of the public interest standard expressly invoked in § 56-590 B 3. It is, after all, only in the examination of these plans

that the Commission can determine whether incumbents will be able to support, in fact, their default service obligations.

Section 56-585 C also requires that the Commission shall "establish such requirements for providers and customers as it finds necessary to promote the reliable and *economic* provision of such services and to prevent the inefficient use of such services." (Emphasis supplied.) Thus, the Commission is required to set rates for default service and to promote "reliable and economic" service. The phrase "reliable and economic" must inform our construction of "generation assets or their equivalent" in § 56-590 B 3. Simply put, the Commission cannot fulfill its statutory obligation under § 56-585 to determine rates and promote "reliable and economic" default service unless it also requires incumbent electric utilities filing functional separation plans under § 56-590 to have in place generation assets, or their equivalent, sufficient to fulfill the incumbents' price and capacity obligations established under § 56-585.

We also note that under the Act, regulated rate protection for default service customers continues until the General Assembly decides to eliminate or alter its provision. Section 56-585 D requires the Commission to convene annual proceedings (commencing in 2004) to assist the General Assembly in its consideration of this important issue. Specifically, the Commission, after notice and an opportunity for hearing, will determine whether there is a sufficient degree of competition such that default service can be discontinued for particular customers, classes of customers, or geographic areas of the Commonwealth, and that any such discontinuance will not be contrary to the public interest. The Commission will report its findings to the General Assembly and the Legislative Transition Task Force, not later than December 1, 2004 and annually thereafter. The General Assembly has, in § 56-585 D, established an essential connection between the termination of default service and the development of sufficient

competition within the Commonwealth. This connection is firmly grounded in the language of § 56-585. Subsections C and D of § 56-585 work together to provide regulated default service and rates to Virginians requiring or desiring it until the market can provide what default service must provide under this statute: reliable *and* economic service.

It bears emphasizing that the scope of § 56-585 encompasses service for those electric customers that (i) choose not to shop for a competitive supplier, (ii) are unable to shop, or (iii) sign up with a competitive supplier who at some point fails to perform. These customers are aggregated under the term "default service." As evident from the statute's express, ratemaking language, default service is intended to provide reliable and economic electric service to *all* nonshopping customers—but it is particularly critical for those unable to obtain service from competitive suppliers, i.e., the market.

It is also apparent to us that § 56-585 C establishes ratemaking provisions for the purpose of promoting the economic and reliable provision of default service, that are far more elaborate than the mere flow-through of market-priced power. Under long-settled canons of statutory construction, we cannot simply dismiss these rate-setting provisions as excess verbiage.

Thus, the language in § 56-585, taken as a whole, simply does not support the view that default service is little more than "supplier of last resort" service provided at market-based pricing. We, therefore, conclude that the plain language of §§ 56-590 B 3, 56-582, and 56-585, as written, compels us to ensure that incumbents provide reliable and economic generation, or generation equivalents, in support of their capped rate and default service obligations. In our view, these statutes obligate this Commission to require the information incumbents must provide under 20 VAC 5-202-40 B 6 g, h, and i.

In short, as the Restructuring Act is written, all Virginians have some form of regulated rate protection until competition is deemed to be effective. Section 56-582 provides capped rate protection until July, 2007. The capped rates may be terminated prior to July 2007, upon application of a utility if the Commission determines that there is "an effectively competitive market . . ." for generation service in the utility's service territory. Section 56-585 provides protections for default service that may extend beyond 2007. It is the General Assembly that determines when default service rate protection is to be terminated, presumably when there is effective competition. These rate protections do not perpetuate regulation, but rather protect the public until competition is deemed effective.

As amply evident from our discussion above, the issue of "equivalent generation"—an issue prompted by the provisions of § 56-590 B 3 together with §§ 56-582, and 56-585—has proven to be one of the most controversial issues before the Commission in the course of its rulemaking associated with the Restructuring Act. This is not surprising for three important reasons. First, resolving this issue is more than an academic exercise. Its outcome carries enormous economic implications and will likely determine how quickly incumbents' generation assets will be freed of any residual, public service obligations. Second, the Act itself was the product of three years of intense debate before the General Assembly joint subcommittee charged with determining whether and in what manner electric utility restructuring should come to Virginia. Consequently, virtually every provision in the Act ultimately adopted by the General Assembly as Senate Bill 1269 of 1999 was marked by vigorous contest or hard-fought compromise. Sweeping, complex legislation borne of such circumstances is seldom, when first enacted, the model of precision; the Restructuring Act is no exception. Indeed, it would be surprising if the parties contending over legislation enacted under such circumstances <u>failed</u> to

disagree as to the precise meaning of the many new and undefined phrases and terms contained within it. Third, and closely related to the second point, is the Commission's obligation to read and implement this Act as a whole, and not just those of its parts advocated by various interests. Thus, in addressing this "equivalent generation" issue, the Commission has had the task of interconnecting and harmonizing the statutory provisions identified above, none of which state specifically that "generation or its equivalent" does or does not encompass price as well as capacity. The absence of express language has given rise to this controversy. But, the Commission cannot sidestep its responsibilities simply because the issue is controversial. The General Assembly has established in § 56-590 B 2, a functional separation plan filing deadline of January 1, 2001. Thus, the Commission must act now—even in the face of the controversy spawned by the language in § 56-590 B 3—to promulgate these rules and therefore ensure that Virginia's incumbent electric utilities can meet this critical deadline.

It is important to note that § 56-590 B 1 gives this Commission until January 1, 2002, to work with utilities in finalizing and implementing their functional separation plans. Consequently, while we have made a determination herein, based on the reasoning set forth in detail above, that price *and* capacity are, as a matter of our construction of the *entire* Act, contained within the meaning of "generation or its equivalent," the General Assembly has the opportunity in the upcoming 2001 legislative session to undertake a direct and thorough review of this controversial issue. Any statutory amendments resulting from that review will, of course, be integrated into this Commission's review of incumbents' functional separation plans, and likely would not disturb the overall timeline established by the Act. In so doing, the General Assembly may determine that "generation or its equivalent" should have a meaning other than the one we ascribe to it today. Should it choose to do so, however, we would encourage the

General Assembly, to address directly—in express, statutory language—whether, and to what extent, default service customers should have any explicit, generation price protection following the termination or expiration of capped rates under the Act. Such legislative action would put to rest this controversy and thus send a clear, unambiguous signal to Virginia's electricity customers, Virginia's incumbent electric utilities, and to competitive electric suppliers concerning the exact nature of Virginia's competitive electricity market following the conclusion of capped rates. In the meantime, however, this Commission has—as we must—provided structure and guidance on this issue through the issuance of these rules, subject to such future legislative clarification as the General Assembly may choose to provide.

Finally, we will, by this order, take a preliminary step in aid of any General Assembly consideration of the generation equivalency and default service issues discussed above. The rules we adopt here today provide that we may grant waivers or exemptions from particular provisions on a case-by-case basis (20 VAC 5-202-50 A). Given the controversy discussed above, we have concluded that it is appropriate to grant, on our own motion, a temporary waiver of those provisions in 20 VAC 5-202-40 B 6 g, h, and i, which would otherwise require incumbent utilities to file information regarding costs, pricing and rates related to incumbents' generation assets or their equivalent. We will not require the filing of this information until April 2, 2001. All other information, including reliability and capacity information relating to incumbents' generation assets or their equivalent, as required by 20 VAC 5-202-40 B 6 g, h, and i, shall, however, be filed on or before January 1, 2001.

Moreover, to the extent that any incumbent electric utility files an application under the Utility Transfers Act, Chapter 5 (§ 56-88 et seq.) of Title 56 of the Code of Virginia, pursuant to the provisions of 20 VAC 5-202-50 C, an additional waiver is hereby granted to the extent that

information concerning the effects of any proposed transfer on existing or prospective rates is not required to be filed until April 2, 2001.[3] All other information required to be filed under the Utility Transfers Act shall, however, be filed with the Commission as prescribed by 20 VAC 5-202-50 C.

Should the General Assembly take action in its 2001 session that would (i) render unnecessary the filing of information concerning costs, pricing or rates under 20 VAC 5-202-40 B 6 g, h, or i, or (ii) affect the filing of rate-related information in conjunction with any Utility Transfers Act application filed pursuant to 20 VAC 5-202-50 C, this Order will be amended accordingly. If, however, no such actions are taken by the 2001 General Assembly, then delaying these filings until April 2, 2001 will simply provide additional time for the incumbent utilities to assemble that information. In either event, we will take no final action based on the costs, price and rate information scheduled to be filed on April 2, 2001, prior to July 2, 2001, in order that we may incorporate the effects of any amendments by the General Assembly to this or any related provision of the Act in our final orders concerning each incumbent's restructuring plan. Thus, as set forth above, interested parties and the public can be assured that we will refrain from taking final action concerning this issue until the General Assembly has had an opportunity to address it in its 2001 legislative session. This action by the Commission, therefore, provides all concerned ample time and opportunity to seek modifications or clarifications of the Act concerning this issue, should they so desire.

[3] To the extent that the General Assembly decides to take legislative action concerning § 56-590 B 3, we would strongly recommend that such action be taken with due regard to ensuring that any amendments thereto do not create conflicts between the Restructuring Act and § 56-90 of the Utility Transfers Act, Chapter 5 (§ 56-88 et seq.) of Title 56 of the Code of Virginia.

Accordingly, IT IS ORDERED THAT:

(1) We hereby adopt the Regulations Concerning the Functional Separation of Incumbent Electric Utilities under the Virginia Electric Utility Restructuring Act, appended hereto as Attachment A.

(2) Each incumbent electric utility required to file a functional separation plan under the Act and pursuant to the rules we issue herein, is hereby granted a temporary waiver of those provisions in 20 VAC 5-202-40 B 6 g, h, and i, which would otherwise require such utilities to file information regarding costs, pricing and rates related to incumbents' generation assets or their equivalent. Such information is not required to be filed until April 2, 2001. All other information, including reliability and capacity information relating to incumbents' generation assets or their equivalent, as required by 20 VAC 5-202-40 B 6 g, h, and i, shall, however, be filed on or before January 1, 2001.

(3) To the extent that any incumbent electric utility files an application under the Utility Transfers Act, Chapter 5 (§ 56-88 et seq.) of Title 56 of the Code of Virginia, pursuant to the provisions of 20 VAC 5-202-50 C, information concerning the effects of any proposed transfer on existing or prospective rates is not required to be filed until April 2, 2001. All other information required to be filed under the Utility Transfers Act shall, however, be filed with the Commission as prescribed by 20 VAC 5-202-50 C.

(4) A copy of this Order and the rules adopted herein shall be forwarded promptly for publication in the Virginia Register of Regulations.

Commissioner Miller, dissenting in part and concurring in part:

I write to express my disagreement with the conclusion of my colleagues that Virginia Code §§ 56-585 and 56-590 give us the authority to control the costs of incumbent utilities' generation assets used to support default service under the Restructuring Act. The majority use that conclusion as a basis for adoption of 20 VAC 5-202-40 B 6 g, h, and i. I dissent to the adoption of those rules.[1]

For me, there is no ambiguity in the Restructuring Act with respect to the pricing of electric energy beyond July 1, 2007. One of the central tenets of the Act is that the open marketplace is to be, in the future, the "regulator" of prices paid by consumers for electric energy.[2] While no one would regard this a novel proposition with respect to independent competitive service suppliers, my colleagues have not accepted the propriety of applying this principle to default service under the Act.

Section 56-585.B.3. states that the incumbent electric utility, the distribution utility, or an affiliate thereof, may be required by the Commission to furnish default service. The Act does not set a date by which default service is to end. Sections 56-585.B.3 and 56-585.C specify how the Commission is to regulate default service rates, as I will discuss below.

Section 56-590.B.3 requires that the Commission direct the functional separation of incumbent electric utilities, and states that:

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[1] I also dissent to the adoption of a portion of 20 VAC 5-202-30 B 5 a. The second sentence of that rule provides:

> An affiliated generation company shall be compensated at the lower of fully distributed cost or market price for all nontariffed services, facilities and products provided to the local distribution company.

This rule would also suit the majority's purposes by allowing the Commission to ignore market prices if, for example, the local distribution company were to serve as default supplier, but depend on the affiliated generation company for its power supplies. If market prices were higher than "costs," however determined, in that situation, this rule would also produce results at odds with what I believe to be the intent of the Restructuring Act.

[2] Two exceptions to this principle involve the capped rate period and default services. Each of these is discussed below.

> Consistent with this chapter, the Commission may impose conditions, as the public interest requires, upon its approval of the incumbent electric utility's plan for functional separation, including requirements that (i) the incumbent electric utility's generation assets or their equivalent remain available for electric service . . . during any period the incumbent electric utility serves as default provider as provided for in § 56-585 . . . .

The majority believe that the above provisions of §§ 56-585 and 56-590 authorize the Commission to impose limits on the costs at which generation resources must be devoted to meeting default service requirements, should the incumbent, the distribution company or an affiliate be designated as the default provider. Indeed, this position has found concrete expression, and quantification, in two stipulated cases this year.[3] In each case, the staff and parties negotiated, as a part of the stipulations, that generating assets must be made available during an indeterminate default period at cost levels that, in essence, would have prevailed under traditional cost of service regulation.

Before discussing this position in more detail, it will be helpful to examine other key provisions of the Act. This review will put the above Code sections into the competitive context I believe the legislature intended.

Section 56-577.A.3, provides that, effective January 1, 2002, "the generation of electric energy shall no longer be subject to regulation under this title, except as specified in this chapter." Also, § 56-581.A states that: "subject to the provisions of this chapter after the date of customer choice, the Commission shall no longer regulate rates and services for the generation component of retail electric energy sold to retail customers."

[3] *Application of Delmarva Power and Light Co. for approval of a plan for functional separation of generation pursuant to the Virginia Electric Utility Restructuring Act* (Case No. PUE000086) and *Application of Delmarva Power & Light Co., Connectiv Delmarva Generation, Inc., Connectiv Energy Supply, Inc., for approval of transactions under Chapters 4 and 5 of Title 56 of the Code of Virginia* (Case No. PUA000032), Final Order, June 29, 2000*; Application of The Potomac Edison Co. d/b/a Allegheny Power*, (Case No. PUE000280), Order Approving Phase I Transfers, July 11, 2000.

While these broad pronouncements favoring competition are admittedly made subject to other portions of the Act, they do set the tone for the overall principle described above, namely, that generation is to be deregulated in Virginia and that, as a necessary consequence, it is the market that is to set prices for electric energy after July 1, 2007.

The Act's provisions affecting capped rates reinforce this principle. Section 56-582.C states that, after January 1, 2004 (not coincidentally, the date by which all customers can "shop"), utilities may petition the Commission to terminate capped rates, and we may do so if we find "an effectively competitive market" for generation services within the service territory.

Importantly, this section contains no reference to the question of what price levels might be produced by such a market.[4] Thus, if we find the market effectively competitive, we may terminate capped rates, even if competitive prices are different than they would have been under regulation, or "should be" according to some other viewpoint. Again, the goal of the Act is the development of a competitive market, not prices that are constrained indefinitely in some artificial fashion.

The fact that the General Assembly allowed for the possibility that even the consumers' rate cap protection, one of the centerpieces of the Act, could be eliminated early under circumstances of effective competition should bear heavily on how we react to views concerning other portions of the Act. In particular, we should look with skepticism at the contention that functionally separated generation plant can still be cost regulated for the benefit of default customers, even after the end of the rate cap period in 2007.

It is not necessary to rely on other portions of the Act, however; the default service section itself embodies the same principle. Section 56-585.D states that, by July 1, 2004, and annually thereafter, the Commission must decide "whether there is a sufficient degree of

[4] I do not deny that price levels might be relevant as to whether a market is "effectively competitive," but they would be considered with all other evidence on the point.

competition such that the elimination of default service . . . will not be contrary to the public interest." Again, the important question is whether competition is sufficient. That is not the same inquiry as to whether prices are "just and reasonable," "affordable," or other terminology concerned with the actual level of prices produced by that competition.

This passage supports my belief that the General Assembly's principal concern in enacting the default service provision was to protect consumers against the possibility that sufficient competitors and resources would not be available in the open market. If no such scarcity exists, then consumers will have adequate choices available to them, and default service will no longer be needed as a "safe harbor." However, I cannot find that this statute evinces a concern with the prices consumers will face from those "sufficient" competitors.

By contrast, the purpose of the capped rate period, in my view, was to furnish price protection for a certain reasonable period after the advent of the competitive era to give competitors a chance to enter the Virginia market, and to allow consumers time to become comfortable with this new structure without exposure to fluctuating prices.

Thus, the rate cap and default service provisions serve two distinct functions, and they should not be confused. The rate cap provisions supply price protection; the default service provisions furnish resource protection. Attempts to regulate the costs of generation resources devoted to default service are an effort to perpetuate rate cap protection longer than the General Assembly decreed, that is, beyond July 1, 2007.

This conclusion is supported by § 56-582.D, which provides that, until capped rates expire or are terminated early, the incumbent electric utility must provide those rates to any customer in its territory. Thus, although customers enjoy the protection of capped rates while they are in effect, there is no guarantee that prices will remain at such "pre-deregulation" levels when those rates end.

With this background, I will now discuss the key provisions of § 56-590.B.3. As noted, that section states that the incumbent electric utility may be required, as a condition of its functional separation plan, to ensure that its "generation assets or their equivalent remain available" during any period it is providing default service. It first should be emphasized here that we are given the discretion whether to impose any such requirements. The statute says, "the Commission may impose conditions . . .." We are not required to implement any measures of this nature. We should, therefore, be cautious of mandating specific conditions unless they are supported by a reasonable interpretation of the Act.

One must now consider whether the language of § 56-590 justifies the imposition of cost controls on generation assets. If so, such language was truly a strange way to phrase that principle. "Generation assets" can obviously "remain available" to serve load, regardless of the cost of those assets. Would it have not been clearer to state, for example, that the Commission could require that the incumbent's "generation assets or their equivalent remain available for electric service during the default service period at costs that are found by the Commission to produce rates that are reasonably affordable," or some similar standard?

Given the clear dependence placed on the competitive market by the Act, a cost component cannot reasonably be grafted onto the "assets remain available" concept in the absence of some clear indication that the General Assembly intended this reading, of which I find none. I further note that § 56-590.B.3 begins by stating that any conditions imposed by the Commission on functional separation are to be "consistent with this chapter," a chapter replete with reliance on competitive markets. In addition, rules are only to be adopted under § 56-590.D "to the extent necessary to promote effective competition."

Section 56-590.B.3, when read in its proper perspective, merely expresses a complementary concept to similar provisions in §§ 56-579.D.3 and 56-587.B. In the latter passages, the Commission is given authority to ensure that even competitive suppliers have

sufficient resources, "including necessary reserve requirements," and "adequate access to generation and generation reserves" to supply their customers. By the same token, under § 56-590 we can require incumbents to maintain the physical capacity to serve default load if they are assigned that responsibility. Importantly, none of these statutes grants the Commission cost controls as one of its tools.

Another section of the Act does give the Commission pricing authority in certain exceptional situations. However, even this section illustrates that competition is to be the guiding principle, and that as long as an adequately functioning market sets the price levels, they may not be modified by the Commission. Section 56-578.G declares that, if the Commission determines that a person has "market power" within a transmission constrained area, the Commission may, subject to certain carefully prescribed limitations, adjust rates for services within that area, "only to the extent necessary to protect retail customers from such market power." The Act defines "market power" as:

> The ability to impose on customers a significant and nontransitory price increase on a product or service in a market above the price level which would prevail in a competitive market.

(Emphasis supplied.)

Thus, even in these critical circumstances, the Commission may protect consumers by adjusting prices only to levels "which would prevail in a competitive market." Whether we believe those competitive prices are "reasonable," or whether they are higher than they would have been under traditional regulation, should be of no consequence under this Act, even when dealing with such anti-competitive forces as market power.

I now turn from § 56-590 to discuss § 56-585.B.3 and C. Here, as I acknowledged in footnote 1, supra, there are provisions giving the Commission authority to regulate the rates charged for default service. Those who would disagree with my position on this issue will thus

ask, what more is necessary? If you can regulate the rates paid by default customers, what greater authority do you need?

In discussing § 56-590 above, my view of the Act rejects the contention that we can regulate the costs of crucial resources that make up part of the expense of serving those customers. In contrast, critical to understanding the provisions of § 56-585.B.3 & C is that they deal with regulating the retail rates paid by default customers. This is a very substantive difference.

An analogy to traditional cost of service regulation may help. Assume that a utility had a purchased power contract for a number of years that provided power at two cents per kWh. Retail rates in the past would obviously have included those costs. Now assume that, prior to the next rate case, the contract expired and had to be replaced by one that cost three cents per kWh. In the next case, the utility presumably would seek to recover those increased costs. Upon proper proof of these facts, the Commission would have two basic options. If adequate evidence were adduced that the new contract had been imprudently procured, its costs could be disallowed. However, in the absence of such evidence, the new rates would normally be set to recover the costs of this more expensive power.

That was the essence of traditional ratemaking. While rates paid by consumers were certainly regulated by the Commission, it had little power, in the absence of a finding of imprudence, to control the costs of the basic goods and services that were purchased for the public service. Most of such cost elements were allowed to be recovered through rates.

Here, however, the approach of the rules adopted by the majority is to attempt to reach deeper into the subject than a review of the relevant, legitimate expenses of the default supplier. The suggestion that the costs of generating assets devoted to default service should be controlled is an attempt to manage those expense levels directly. In my example above, this approach

would cause the costs of the new power purchase agreement to be ignored in future cases, and the utility to be treated as if the expired contract for less expensive power were still in effect.

This treatment would be applied, not because of any finding of imprudence, but simply because the old contract was cheaper than the new one. In the present context, I believe this approach is simply an attempt to safeguard consumers against competitive market prices, because those prices might turn out to be higher than levels that would result from treating the utility as if the Act had changed nothing with regard to its generation assets. While perhaps an understandable motive, I find it inconsistent with the overall objective of the Act. After the period of rate cap protection, the costs of generation are to be set by the market, not by regulators.[5]

Relevant provisions of § 56-585 support this conclusion. It bears noting that § 56-585 expresses an initial preference that we select default service providers other than the incumbent electric utility or distribution company.

Subdivision B.1 of that section sets forth the criteria that we are to apply when selecting a provider. Among them are cost, experience, safety, reliability, corporate structure, and access to electric energy resources. These factors apply, of course, to consideration of other suppliers just as they do to the local utility. Next, subdivision B.2 states that the Commission may "designate one or more willing providers" of default service. In such a case, does the Act allow us to control the "cost" of generation in the stringent sense? Hardly, if we expect to find a "willing provider." Cost is obviously an important feature for comparison in choosing among possible volunteers for such duty, but we should not expect such cost to be amenable to our direct control. Why then should we expect it if we instead designate the utility as the provider?[6]

[5] I will explain below why the motive of price protection after the end of the rate cap period is also not a good one for public policy reasons.

[6] As discussed below, the policy implications of such an approach could be quite serious.

It is only after describing the process of seeking a "willing provider" that the Act states, in subsection B.3:

> In the absence of a finding under subdivision 2, [the Commission] may require an incumbent electric utility . . . to provide . . . such services, . . . at rates which are fairly compensatory to the utility and which reflect any cost of energy prudently procured, including energy procured from the competitive market.

(Emphasis supplied.)

Thus, the local utility does not have the option of refusing the call, as do competitive suppliers. It does not matter whether the utility is "willing." In return, however, the statute provides certain protections to the utility.

First, the rates must be "fairly compensatory." In my view of this Act, whether a rate is fairly compensatory to a utility directed to provide default service should be determined with reference to the concept of "foregone opportunities." Proponents of the notion of continued regulation of generation costs fear that market prices might be higher than the utility's embedded cost of service under traditional principles. If such is the case, then the utility is being forced to give up the opportunity of selling its power at higher prices in the competitive market in order to supply default service. I would therefore not deem it "fairly compensatory" to fix rates on old ratemaking principles under such a state of facts. Rather, the utility should be compensated at levels it could realize in the competitive market, were it free to do so.

Second, the above portion of the Act recognizes explicitly that such compensation is to cover the cost of energy prudently procured, including that obtained from the competitive market. The Act thereby again encourages reliance on the competitive market.

Subsection C of § 56-585 next provides that the Commission is to set

> the rates, terms and conditions for such services consistent with the provisions of subdivision B.3 and Chapter 10 . . . and shall establish such requirements for providers and customers as it finds necessary to promote the reliable and economic provision of such services and to prevent the inefficient use of such services. The

> Commission may use any rate method that promotes the public interest . . ..

This section, relied on by the majority, does not support their position. It first references subdivision B.3, which I discuss above. That section does not apply to suppliers of default service other than the local utility or its progeny. On the other hand, the reference to Chapter 10 in subsection C appears to apply to both types of entities.

The latter point helps put this mention of Chapter 10 in proper context. Rates charged by suppliers are to be determined "consistent with the provisions of . . . Chapter 10." What can that statement possibly mean in the context of selecting a "willing provider" for default services. Does it mean, in the words of § 56-235.2, a part of Chapter 10, that the rates of such a provider are

> to be considered to be <u>just and reasonable only if</u>: (1) the public utility has demonstrated that such rates, tolls, charges or schedules in the aggregate provide revenues <u>not in excess of the aggregate actual costs incurred</u> by the public utility in serving customers within the jurisdiction of the Commission, . . . and <u>a fair return</u>[?]

(Emphasis supplied.)

How many "willing providers" would we find if it became known that such standards would be applied to their voluntary participation in Virginia's default service program? Such interpretation would frustrate one of the major tenets of an attempt by the legislature to assure the provision of default service, with a reasonable opportunity for competitive suppliers to provide such service. If this treatment could not successfully be applied to such companies, why then should we attempt to subject the local utility to it? This point indicates that the brief reference to Chapter 10 in this statute is not as all encompassing as it might first appear.

Subdivision C goes on to discuss the establishment of

> requirements for providers and customers . . . to promote the reliable and economic provision of such services and to prevent the inefficient use of such services.

This clause is not referenced to the standards of Chapter 10, or § 56-585.B.3. It thus is not necessarily related to the ratemaking aspects of default service. I believe it has greater relevance to the Commission's need for authority to prevent "gaming" of the system by customers and suppliers, or the improper and uneconomic use of default service in situations not intended by the Act.

In any event, the final sentence of § 56-585.C is perhaps the most important for the purposes of this discussion:

> The Commission may use any rate method that promotes the public interest . . ..

I believe that the public interest would be best promoted by basing default service retail rates on market-determined costs for the generation resources that will be required to support that service. In addition to the fact that the Act's relevant provisions sustain this result, as discussed above, sound public policy reasons underlie it.

As I noted earlier, the fundamental reason to seek to continue cost of service regulation of generation assets related to default service appears to be the fear that market determined costs might be higher in the future than the embedded costs associated with those resources. If one assumes that scenario to be accurate, then default customers' rates could increase beyond a level that some would consider "reasonable." But, consider the alternative:

- If it becomes clear to the market at large that the local utility's rates for default service are subject to restraints of the above nature, it is unlikely that any other suppliers will seek to win the default service business. The utility will thus be selected by "default."
- After that designation, there will also be no incentive for other players to enter Virginia, even as competitive providers. Why should they, if they know that their

rates are effectively "capped" by lower-than-market default rates? Thus, consumers will have few options to default service, and they will remain there.

- Since the Act provides no ending date for default service, the dearth of competitive suppliers will self-perpetuate the need for the default option, long past the end of the capped rate period.
- The final result of this improper handling of default service, which the Act intended to be only a temporary measure until the development of "a sufficient degree of competition" (§ 56-585.D), could well be that no such market ever develops in Virginia. The overall competitive goal of the Act would thus be frustrated.

In conclusion, the Act sets up competition in generation as the ultimate goal of deregulation. Since capped rates have a finite existence under the Act, but default service does not, the position of the majority can result in the perpetuation of price cap regulation into the indeterminate future. The result of the order as now framed does not sufficiently recognize that deregulation of generation, competitive choice, and functional separation are key facets of the Act. The Act will not support such an interpretation.

While I dissent to the actions of the majority discussed above, I concur with the procedural provisions of this order that grant a temporary waiver of the effectiveness of the filing requirements of 20 VAC 5-202-40 B 6 g, h, and i until April 2, 2001, with the Commission delaying action thereon until July 2, 2001. These delays will give the General Assembly an opportunity, during the upcoming 2001 legislative session, to "undertake a direct and thorough review" of the very important substantive issues involved here. Should legislation result, it will be effective before the Commission acts under the delayed schedule announced here. Since, as I have explained, I do not agree with the majority's interpretation of §§ 56-585 and 56-590 in the

first place, I am agreeable that the General Assembly be given a chance to consider these matters before there be any possible substantive application of the disputed rules.

Because of the serious controversy arising from the language of these sections, it is appropriate that the General Assembly address these important aspects of the Act, and to establish clearly the policy of the Commonwealth, rather than for the Commission to take steps that might be contrary to such policy.

_____

Clinton Miller, Commissioner

CHAPTER 202.

REGULATIONS GOVERNING THE FUNCTIONAL SEPARATION OF INCUMBENT ELECTRIC UTILITIES UNDER THE VIRGINIA ELECTRIC UTILITY RESTRUCTURING ACT.

20 VAC 5-202-10. Applicability and scope.

These regulations are promulgated pursuant to the provisions of the Virginia Electric Utility Restructuring Act (§ 56-576 et seq. of the Code of Virginia), and they apply only to incumbent electric utilities subject to the provisions thereof. Section 56-590 of the Act declares that all incumbent electric utilities shall functionally separate their generation, transmission and distribution services by January 1, 2002, and that such functional separation may be accomplished through the creation of affiliates, or through such other means as may be acceptable to the commission. The utilities are required to submit proposed functional separation plans to the Virginia State Corporation Commission by January 1, 2001.

Section 56-590 B 3 of the Act authorizes the commission to impose conditions, as the public interest requires, upon its approval of incumbent electric utilities' plan for functional separation, including requirements that (i) incumbent electric utilities' generation assets or their equivalent remain available for electric service during the capped rate period as provided in § 56-582 and, if applicable, during any period incumbent electric utilities serve as default providers pursuant to § 56-585, and (ii) incumbent electric utilities receive commission approval for the sale, transfer or other disposition of generation assets during the capped rate period and, if applicable, during any period incumbent electric utilities serve as default providers.

Pursuant to § 56-590 C, the commission is also directed, to the extent necessary to promote effective competition in the Commonwealth, to promulgate regulations:

1. Prohibiting cost-shifting or cross-subsidies between functionally separate units;

2. Prohibiting functionally separate units from engaging in anticompetitive behavior or self-dealing;

3. Prohibiting affiliated entities from engaging in discriminatory behavior toward nonaffiliated units; and

4. Establishing codes of conduct detailing permissible relations between functionally separate units.

Additionally, § 56-590 F provides, in pertinent part, that nothing in the Virginia Electric Utility Restructuring Act shall be deemed to abrogate or modify the commission's authority under Chapters 3 (§ 56-55 et seq.), 4 (§ 56-76 et seq.) or 5 (§ 56-88 et seq.) of Title 56 of the Code of Virginia.

These regulations, therefore, implement the statutory provisions of the Virginia Electric Utility Restructuring Act described above, and are intended to aid incumbent electric utilities required to (i) functionally separate their generation, transmission and distribution services by January 1, 2002, and (ii) submit applications for such purpose to the commission by January 1, 2001. Such regulations shall not, however, be deemed to modify or supercede any regulations adopted by the commission concerning the relationships between local distribution companies and any company licensed by the commission to provide competitive energy services, which regulations shall include the commission’s Interim Rules Governing Electric and Natural Gas Retail Access Pilot Programs 20 VAC 5-311-10 et seq. and any successor regulations thereto.

20 VAC 5-202-20. Definitions.

The following words and terms when used in this chapter shall have the following meaning unless the context clearly indicates otherwise:

"Act" means the Virginia Electric Utility Restructuring Act.

"Affiliated generation company" means a generation company that controls, is controlled by, or is under common control with a local distribution company. For purposes of this chapter, any unit or division created by a local distribution company for the purpose of acting as a generation company shall be treated as an affiliated generation company and shall be subject to the same provisions and regulations.

"Commission" or "SCC" means the Virginia State Corporation Commission.

"FERC" means the Federal Energy Regulatory Commission.

"Generation company" means a person owning, controlling, or operating a facility that produces electric energy for sale to wholesale customers.

"Incumbent electric utility" shall have the same meaning as set forth in § 56-576 of the Code of Virginia.

"Local distribution company" means an entity regulated by the Virginia State Corporation Commission that owns or controls the distribution facilities required for delivery of electricity to the end-user.

"Market price" or "market value" means the value of comparable goods or services determined through such methods as competitive bidding, appraisals, catalog listings, sales to third parties and asset replacement cost determinations.

"Person" shall have the same meaning as set forth in § 56-576 of the Code of Virginia.

"Transmission provider" means an entity regulated by the Federal Energy Regulatory Commission (FERC) that owns or operates, or both, transmission facilities.

20 VAC 5-202-30. Relations between affiliated functionally separated entities; SCC oversight.

A. The following practices are prohibited:

1. Cost-shifting or cross-subsidies between functionally separate units;

2. Anticompetitive behavior or self-dealing between functionally separate units; and

3. Discriminatory behavior by affiliated entities toward nonaffiliated units.

B. The following provisions apply to (i) the relationships between a local distribution company and any affiliated generation company following the commission's approval of their functional separation, and (ii) the commission's oversight of such affiliated companies:

1. The local distribution company shall not give undue preference to an affiliated generation company over the interests of any other generation company. For purposes of this subdivision, "undue preference" means a preference that is reasonably likely to affect adversely the development of effective competition within the Commonwealth.

2. To the extent local distribution companies administer or otherwise furnish fuel supply services, such companies shall provide information related to fuel or fuel supply resources to an affiliated generation company only if it makes such information simultaneously available, through an electronic bulletin board or similar means of public dissemination, to all other generation companies conducting business in Virginia. Nothing in this subdivision shall require any local distribution company to disseminate to

all generation companies information requested and deemed competitively sensitive by a generation company and supplied by the local distribution company. This subdivision is not applicable to daily operational data provided by the local distribution company to any generation company in the ordinary course of conducting business.

3. Affiliated local distribution and generation companies shall maintain separate records and accounts for functionally separate units and separate books of account for separate legal entities.

4. Each local distribution company shall operate independently of any affiliated generation company and shall observe the following requirements:

a. Each local distribution company shall establish and implement internal controls to ensure that such company and its employees who are engaged in (i) merchant operations, transmission, or reliability functions of electric generation or natural gas supply systems, or (ii) customer service, sales, marketing, accounting or billing functions, do not provide information to an affiliated generation company or to entities that provide similar functions for or on behalf of such an affiliated generation company that would give any such affiliated generation company an undue advantage over nonaffiliated generation companies. For purposes of this subdivision, "undue advantage" means an advantage that is reasonably likely to affect adversely the development of effective competition within the Commonwealth.

b. Each local distribution company shall file with the commission, a listing and description of all internal controls implemented pursuant to this section as

provided for in 20 VAC 5-202-40 or within 10 days subsequent to any modification of such controls.

5. Local distribution companies shall be subject to the following requirements concerning affiliate transactions:

a. Local distribution companies shall be compensated at the greater of fully distributed cost or market price for all nontariffed services, facilities, and products provided to an affiliated generation company. An affiliated generation company shall be compensated at the lower of fully distributed cost or market price for all nontariffed services, facilities, and products provided to the local distribution company. If market price data are unavailable for purposes of such calculations, nontariffed services, facilities and products shall be compensated at fully distributed costs. In such event, the local distribution company shall document its efforts to determine market price data and its basis for concluding that such price data are unavailable. Notification of a determination of the unavailability of market price data shall be included with the report required in b of this subdivision.

b. Local distribution companies shall file annually, with the commission, a report that shall, at a minimum, include: (i) the amount and description of each type of nontariffed service provided to or by an affiliated generation company; (ii) accounts debited or credited; and (iii) the compensation basis used (i.e., market price or fully distributed cost). The local distribution company shall make available to the commission's staff, upon request, the following documentation

for each agreement and arrangement where services are provided to or by an affiliated generation company: (i) component costs (i.e., direct or indirect labor, fringe benefits, travel or housing, materials, supplies, indirect miscellaneous expenses, equipment or facilities charges, and overhead); (ii) profit component; and (iii) comparable market values and documentation.

6. Affiliated generation and local distribution companies shall document each occasion that (i) an employee of one becomes an employee of the other or of any transmission provider that services either, or (ii) an employee of any transmission provider that services any such affiliated distribution company or generation company becomes any employee of either. Upon request of the commission's staff, such information shall be filed with the commission identifying each such employment described in this subdivision. This information shall include a listing of each employee transferred and a brief description of each associated position and responsibility.

7. The commission may inspect the books, papers, records and documents of, and require special reports and statements from, every generation company affiliated with a local distribution company regarding transactions with its local distribution company affiliate. Upon complaint or on its own initiative, the commission may also (i) investigate alleged violations of this chapter, and (ii) seek to resolve any complaints filed with the commission against any such affiliated generation company.

20 VAC 5-202-40. Application for functional separation.

A. Each incumbent electric utility required by the Act to functionally separate its generation, transmission and distribution services shall submit a plan to the commission therefor by January 1, 2001, conforming to the requirements set forth below. In addition to information specifically required under this chapter, the incumbent electric utility shall provide any information or documentation it believes will assist the commission in evaluating such utility's functional separation plan.

B. Each plan submitted by an incumbent electric utility shall, at a minimum, contain the following provisions or information. If such information is not available as of the date of the filing, the application shall contain a detailed explanation as to why such information is not available, the efforts under way to develop such information, and an estimate of the time within which it will be available.

1. A table of contents detailing the plan's components, that shall include, at a minimum, a list of testimonies, schedules, supporting witnesses and issues addressed.

2. An executive summary of the functional separation plan that shall include the following:

a. An overview of the present structure of the integrated utility.

b. An overview of the proposed functional separation plan, including but not limited to, the following issues or matters:

(1) The specific type of functional separation proposed (e.g., transfer to an affiliate or division, divestiture, etc.) with an assessment of how such method will comply with § 56-590 of the Code of Virginia.

(2) A timeline for implementing the functional separation plan's major components.

(3) A description of measures proposed to ensure that the proposed plan of functional separation will not jeopardize or impair the safety or reliability of the incumbent electric utility's generation, transmission, and distribution systems.

(4) The estimated amount of assets and liabilities (including deferred taxes) proposed to be transferred to each functionally separate entity or third party.

(5) The estimated cost of the proposed plan of functional separation.

(6) Measures proposed in the plan to enable the incumbent electric utility to (i) meet potential obligations to provide capped rate service and default service, and (ii) assure that generation assets or their equivalent remain available during the capped rate and default service periods established under the Act.

c. A list of specific approvals sought by the incumbent electric utility in conjunction with its functional separation plan, identifying the sections of the Code of Virginia under which each such approval is sought, and describing the proposed timeframe for each such approval.

d. A summary of any other information the incumbent electric utility believes will be helpful to the commission in assessing the proposed functional separation plan.

e. Waivers that the incumbent electric utility is requesting from the requirements of this chapter, and the reasons therefor.

f. Exemptions that the incumbent electric utility is requesting pursuant to § 56-590 F from the provisions of Chapter 5 (56-88 et seq.) of Title 56 of the Code of Virginia.

3. An assessment of the financial impact of the proposed functional separation plan, including information concerning the following:

a. The capital structure and cost of capital, including any transaction or refinancing costs, of the functionally separate entities resulting from the proposed plan used to calculate the unbundled cost of capital supporting the cost of service study required by subdivision 7.

b. The manner in which any assets are proposed to be transferred in the form of a dividend from any proposed functionally separate entity to any parent entity thereof incident to functional separation.

c. A description of (i) how the local distribution company will account for a wires charge and (ii) how a wires charge will impact the financial statements of the local distribution company.

d. Any other financial information relevant to the incumbent electric utility's proposed functional separation plan.

4. Information concerning the proposed structure of each functionally separate entity, as follows:

a. The legal structure of each functionally separate entity proposed in the functional separation plan (e.g., corporation, limited liability company, limited liability partnership, etc.).

b. The names and addresses of each proposed functionally separate entity's officers and directors, or their equivalents.

c. The location and mailing address of each proposed functionally separate entity's headquarters.

d. A description of how functional separation requirements in any other states have affected, or may affect, the incumbent electric utility, its structure and operations.

e. A description of all federal agency approvals required in connection with the execution and implementation of the incumbent electric utility's proposed functional separation plan, identifying any state commission findings (i) required in conjunction with such federal agency approvals, or (ii) otherwise required pursuant to federal law.

f. A timeline for implementing major elements of the functional separation plan.

5. Information concerning separation of functions and operations, as follows:

a. A description of the products and services to be offered by any proposed functionally separate entity.

b. A description of functions and services to be transferred from the incumbent electric utility to any proposed functionally separate entity.

c. A description of competitive services to be offered by each functionally separate entity of the incumbent electric utility.

d. Information concerning the total number of incumbent electric utility employees proposed to be (i) transferred to any proposed functionally separate entity, or (ii) jointly employed by any proposed functionally separate entities, following functional separation.

e. A detailed description of measures proposed to ensure the safety and reliability of the incumbent electric utility's generation, transmission and distribution system in conjunction with functional separation.

f. An estimate of the cost of functional separation, and an explanation of how the costs thereof will be shared among the proposed functionally separate entities.

g. A list and description of the internal controls established to ensure that the local distribution company and its affiliated generation company operate independently as required by 20 VAC 5-202-30 B 4.

6. Information concerning asset and liability transfers or sales, as follows:

a. A list of assets or liabilities that the incumbent electric utility proposes to transfer to a functionally separate entity or proposes to sell to a third party. The list shall include the FERC account number, book value, proposed transfer date and the recipient of the assets or liabilities.

b. The method used to value the transfer of assets to a functionally separate entity or to a third party, and justification for the chosen methodology.

Information furnished shall include documentation supporting the valuation and transfer thereof.

c. If the Legislative Transition Task Force adopts a resolution requesting the commission's assistance with monitoring the recovery of net stranded costs pursuant to § 56-595 C of the Act, then the following information shall be provided to the commission: (i) fair market value of each generation and transmission asset functionally unbundled, transferred or sold to a third party or affiliate; and (ii) a list of all long-term power contracts functionally unbundled, transferred or sold to a third party or affiliate. Information furnished shall include the length and anticipated expiration date of each contract, annual cash payments for power, and the market value of each power contract for each year of its remaining life.

d. Detailed documentation supporting (i) the accounting for the proposed transfer or divestiture of generation assets, and (ii) projected impacts of such transfers or divestiture on current and deferred income taxes. The information furnished shall include the income statement and balance sheet effects of income taxes, both before and after the proposed transfer or divestiture.

e. A copy of the proposed system of accounts, if other than the FERC uniform system of accounts, that any affected affiliated generation company will use for booking purposes.

f. A list of new investments (including amounts and time period) necessitated by the incumbent electric utility's proposed functional separation plan.

g. In furtherance of the commission's responsibility under § 56-590 B 3 of the Code of Virginia, each incumbent utility shall provide an assessment of how its proposed functional separation plan advances or satisfies such utility's obligation to make electric service available at the capped rates established under § 56-582 D.

h. In furtherance of the commission's responsibility under § 56-590 B 3 of the Code of Virginia, each incumbent utility shall provide an assessment of how its proposed functional separation plan advances or satisfies such utility's potential obligation to provide electric service as a default supplier pursuant to § 56-585. Such assessment shall include a detailed description of pricing and capacity if the incumbent electric utility proposes to utilize equivalent generation in satisfaction of such obligation.

i. An analysis comparing the cost of obtaining equivalent generation to the cost of retaining generation assets if the incumbent electric utility proposes to divest all or part of its generation assets supporting its Virginia load. The information furnished shall explain how such equivalent generation will produce rates, reliability and capacity that are at least comparable to that provided by the generation assets currently held by the incumbent electric utility. Additionally, the

information shall include the incumbent electric utility's assessment of how obtaining equivalent generation is in the public interest.

7. Information concerning a cost of service study as follows:

a. A cost of service study, based on a test year beginning no earlier than January 1, 1999, reflecting total company and total Virginia operations.

b. A cost of service study that separates total Virginia operations identified in a of this subdivision into Virginia jurisdictional and Virginia nonjurisdictional operations.

c. A cost of service study that separates Virginia jurisdictional operations established under b of this subdivision, by class and function utilizing the rate of return approved by the commission in the incumbent electric utility's most recent rate case or alternative regulatory plan. Class costs shall be subdivided by generation, transmission, distribution, metering, billing, and other customer services as may be warranted or required by the commission. Such divisions shall be further subdivided as demand, energy and customer. The class study shall include computations of the average price per unit for these various subdivisions.

8. The incumbent electric utility's proposed unbundled tariffs, rates, terms and conditions.

9. A description of how the incumbent electric utility's proposed functional separation will comply with 20 VAC 5-202-30.

20 VAC 5-202-50. Waiver or exemption requests; confidential information; other filings.

A. Any request for a waiver of any provision in this chapter shall be considered by the commission on a case-by-case basis, and may be granted upon such terms and conditions as the commission may impose.

B. Where a filing, made pursuant to this chapter, contains information that the applicant claims to be confidential, the filing may be made under seal provided it is accompanied by both a motion for protective order or other confidential treatment and an additional five copies of a redacted version of the filing to be available for public disclosure. Unredacted filings containing the confidential information shall be maintained under seal unless and until the commission rules otherwise, except that such filings shall be immediately available to the commission staff for internal use at the commission.

Filings containing confidential (or redacted) information shall be so stated on the cover of the filing, and the precise portions of the filing containing such confidential (or redacted) information, including supporting material, shall be clearly marked within the filing.

C. Each incumbent electric utility shall file simultaneously with its functional separation plan its application for transfer of assets pursuant to the Utility Transfers Act, Chapter 5 (§ 56-88 et seq.) of Title 56 of the Code of Virginia, if any, except for good cause shown.

D. Any incumbent electric utility requesting an exemption pursuant to § 56-590 G from the provisions of Chapter 5 (§ 56-88 et seq.) of Title 56 of the Code of Virginia, to the extent that any such incumbent electric utility's proposed functional separation plan includes a covered transaction otherwise subject to the provisions of § 56-590 shall clearly identify such request in its functional separation plan filed with the commission.